

<b>Bath &amp; North East Somerset Council</b>		
MEETING:	<b>AVON PENSION FUND COMMITTEE</b>	
MEETING DATE:	<b>22 September 2017</b>	<b>AGENDA ITEM NUMBER</b>
TITLE:	<b>Implementation of the Markets in Financial Instruments Derivative (MiFID II)</b>	
WARD:	ALL	
<b>AN OPEN PUBLIC ITEM</b>		
List of attachments to this report:		
Appendix 1 - Retail Client Protections		
Appendix 2 – Opt up information template		

## **1 THE ISSUE**

- 1.1 This report outlines the impact of the implementation of the Markets in Financial Instrument Directive 2014/65 (“MiFID II”) and in particular the risk to the Fund of becoming a retail client on 3 January 2018 and recommends that the committee agree that elections for professional client status should be made on behalf of the Fund immediately given the deadline.

## **2 RECOMMENDATION**

**That the Committee:**

- 2.1 **Notes the potential impact on investment strategy of becoming a retail client with effect from 3 January 2018.**
- 2.2 **Agrees to the immediate commencement of applications for elected professional client status with all relevant institutions in order to ensure it can continue to implement an effective investment strategy.**
- 2.3 **In electing for professional client status, the committee acknowledges and agrees to forgo the protections available to retail clients attached as Appendix 1.**
- 2.4 **Approve delegated retrospective responsibility to the Head of Pensions and Investments Manager for the purposes of completing the applications and determining the basis of the application as either full or single service.**
- 2.5 **Notes that each committee member will be required to complete a self-assessment of their investment knowledge as part of the opt up process.**

### **3 FINANCIAL IMPLICATIONS**

- 3.1 The budget provides for all investment manager fees that have been agreed given the Fund's current status as a 'per se professional' client. If the Fund was does not opt up under MIFID II and remains categorised as a 'retail client', the Fund would be at risk of higher investment manager fees reflecting its retail status.
- 3.2 If the Fund does not opt up it may have to divest from some of its portfolios which would incur trading costs and it may not be able to implement its investment strategy.

### **4 REGULATORY CONTEXT**

- 4.1 Under the current UK regime, local authorities are automatically categorised as 'per se professional' clients in respect of non-MiFID scope business and are categorised as 'per se professional' clients for MiFID scope business if they satisfy the MiFID Large Undertakings test. Local authorities that do not satisfy the Large Undertakings test may opt up to elective professional client status if they fulfil certain 'opt-up criteria'.
- 4.2 Following the introduction of the MiFID II from 3 January 2018, firms will no longer be able to categorise a local public authority or an LGPS fund as a 'per se professional client'. Instead, all local authorities and their funds must be classified as "retail clients" unless they are opted up by firms to an 'elective professional client' status.
- 4.3 Furthermore, the FCA (as the regulator that sets the rules in the UK) has exercised its discretion to adopt gold-plated opt-up criteria for the purposes of the quantitative opt-up criteria, which local authority clients, in their capacity as administering authority for the LGPS fund, must satisfy in order for firms to reclassify them as an elective professional client.

#### **Potential Impact**

- 4.4 A move to retail client status would mean that all financial services firms like banks, brokers, advisers and fund managers will have to treat the Fund the same way they do non-professional individuals and small businesses. That includes a raft of protections ensuring that investment products are suitable for the customer's needs, and that all the risks and features have been fully explained. This provides a higher standard of protection for the client but it also involves more work and potential cost for both the firm and the client, for the purpose of proving to the regulator that all such requirements have been met.
- 4.5 Such protections would come at the price of The Fund not being able to access the wide range of assets needed to implement an effective, diversified investment strategy. Retail status would significantly restrict the range of financial institutions and instruments available to the Fund. Many institutions currently servicing the LGPS funds are not authorised to deal with retail clients and may not wish to undergo the required changes to resources and permissions in order to do so.
- 4.6 Even if the institution secures the ability to deal with retail clients, the range of instruments it can make available to the client will be limited to those defined under Financial Conduct Authority (FCA) rules as 'non-complex' which would exclude many of the asset classes currently included in LGPS fund portfolios (this could include LDI strategies and infrastructure for example). In many cases

managers will no longer be able to even discuss ('promote') certain asset classes and vehicles with the Fund as a retail client (see Appendix 1 for an explanation of the Retail Protections the Fund would be giving up).

### **Election for professional Client status**

- 4.7 MiFID II allows for retail clients which meet certain conditions to elect to be treated as professional clients (to 'opt up'). There are two tests which must be met by the client when being assessed by the financial institution: the quantitative and the qualitative test.
- 4.8 The Local Government Pension Scheme Advisory Board (SAB) and the Local Government Association (LGA) along with the Department of Communities and Local Government (DCLG) and the Investment Association (IA) have successfully lobbied the FCA to make the test better fitted to the unique situation of LGPS funds.
- 4.9 The new tests recognise the status of LGPS funds as providing a 'pass' for the quantitative test while the qualitative test can now be performed on the Fund as a collective rather than an individual.
- 4.10 The election to professional status must be completed with all financial institutions prior to the change of status on 3 January 2018. Failure to do so by funds would result in the financial institution having to take 'appropriate action' which could include a termination of the relationship at a significant financial risk to the Fund.
- 4.11 The SAB and the LGA have worked with industry representative bodies including the IA, the British Venture Capital Association (BVCA) and others to develop a standard opt-up process with letter and information templates. This process should enable a consistent approach to assessment and prevent funds from having to submit a variety of information in different formats.
- 4.12 The information template including the quantitative and qualitative tests is attached as Appendix 2 for information.
- 4.13 Applications can be made in respect of either all of the services offered by the institution (even if not already being accessed) or a particular service only.; the latter may be appropriate where the institution offers a wide range of complex instruments which the Fund does not currently use and there is no intention to use the institution again once the current relationship has come to an end, for example, if the next procurement is achieved via BPP Ltd. It is recommended that officers determine the most appropriate basis of the application, either via full or single service.
- 4.14 We will not be required to renew elections on a regular basis but will be required to review the information provided in the opt-up process and notify all institutions of any changes in circumstances which could affect our status, for example, if the membership of the committee changed significantly resulting in a loss of experience, or if the relationship with the Fund's advisors terminated.

### **LGPS Pools**

- 4.15 BPP Ltd. will be a professional investor in their own right so will not need to opt up with the external institutions they use. The Fund will however need to opt up with BPP Ltd. in order to access the full range of services and sub-funds on offer. Therefore this process will be undertaken once BPP Ltd is authorised by the FCA.

4.16 Elections to professional status will be needed for every financial institution that the Fund uses outside of the pool, both existing and new, together with a continuing review of all elections. If all new purchases are made via fund structures within the pool then no new elections will be required, only an ongoing review of the elections made with BPP Ltd. and any legacy external institutions, the number of which would reduce as assets are liquidated and cash transferred.

## **5 NEXT STEPS**

5.1 In order to continue to effectively implement the Fund's investment strategy after 3 January 2018, applications for election to be treated as a professional client need to be submitted to all financial institutions with whom the Fund has an existing or potential relationship in relation to the investment of the pension fund.

5.2 This process should commence as soon as possible in order to ensure we meet the deadline and avoids the need for appropriate action to be taken by institutions in relation to the Fund's pension fund investments.

5.3 The Committee are asked to delegate to the officers named in the recommendations the retrospective authority to make applications on the Fund's behalf and to determine the nature of the application on either full or single service basis.

5.4 The qualitative tests include an assessment of the knowledge of the fund's decision making body as a collective. To provide assurance around the knowledge required and training given, all members will be required to complete a self-assessment questionnaire of their investment knowledge.

## **6 RISK MANAGEMENT**

6.1 The Avon Pension Fund Committee is the formal decision-making body for the Fund. As such it has responsibility to ensure adequate risk management processes are in place. It discharges this responsibility by ensuring the Fund has an appropriate investment strategy and investment management structure in place that is regularly monitored. The creation of an Investment Panel further strengthens the governance of investment matters and contributes to reduced risk in these areas.

## **7 EQUALITIES**

10.1 An equalities impact assessment is not necessary.

## **8 CONSULTATION**

8.1 N/a

## **9 ISSUES TO CONSIDER IN REACHING THE DECISION**

9.1 Set out in the report.

## **10 ADVICE SOUGHT**

10.1 The Council's Monitoring Officer (Divisional Director – Legal and Democratic Services) and Section 151 Officer (Strategic Director of Resources) have had the opportunity to input to this report and have cleared it for publication.

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<b>Background papers</b>	
<b>Please contact the report author if you need to access this report in an alternative format</b>	